BEFORE THE

ARIZONA CORPORATION COMMISSION

IN THE MATTER OF QWEST CORPORATION'S FILING OF RENEWED PRICE REGULATION PLAN	)))	DOCKET NO. T-0151B-03-0454
IN THE MATTER OF THE INVESTIGATION OF THE COST OF TELECOMMUNICATIONS ACCESS	)))	DOCKET NO. T-00000D-00-0672

DIRECT TESTIMONY AND SCHEDULES

OF

WILLIAM DUNKEL

ON BEHALF OF

THE STAFF OF THE ARIZONA CORPORATION COMMISSION

NOVEMBER 2004

NOTICE: THE CONFIDENTIAL INFORMATION HAS BEEN REDACTED FROM THIS TESTIMONY.

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I. STATEMENT OF QUALIFICATIONS AND INTRODUCTION

Q. Please state your name and address.

A. My name is William Dunkel. My business address is 8625 Farmington Cemetery Road, Pleasant Plains, Illinois 62677.

Q. What is your present occupation and some highlights of your background?

A. I am a consultant providing services in telephone rate proceedings. I am the principal of William Dunkel and Associates, which was established in 1980. Since that time, I have regularly provided consulting services in telephone regulatory proceedings throughout the country. I have participated in over 140 state regulatory telephone proceedings before over one-half of the state commission in the United States, as shown on Appendix A attached hereto. I have participated in telephone regulatory proceedings for over 20 years. I have provided cost analysis, rate design, jurisdictional separations, depreciation, expert testimony and other related services to state agencies throughout the country in numerous telecommunication state proceedings. I have also provided depreciation testimony to state agencies in several electric utility or natural gas proceedings.

I am a member of the Society of Depreciation Professionals.

During the period 1975-1980, I was the Separations and Settlements expert for the Staff of the Illinois Commerce Commission.

From July, 1977 until July, 1980, I was a Staff member of the FCC-State Joint Board on Separations, concerning the "Impact of Customer Provision of Terminal Equipment on Jurisdictional Separations" in FCC Docket No. 20981 on behalf of the Illinois Commerce Commission. The FCC-State Joint Board is the national board which specifies the rules for separations in the telephone industry.

I have taken the AT&T separations school which is normally provided to the AT&T personnel.

I have taken the General Telephone separations school which is normally provided for training of the General Telephone Company personnel in separations.

I currently provide, or in the past have provided, services in telecommunications proceedings to the following clients:

The Public Utility Commission or the Staffs in the States of:

Alaska	Mississippi
Arkansas	Missouri
Arizona	New Mexico
Delaware	U.S. Virgin Islands
Georgia	Utah
Guam	Virginia
Illinois	Washington
Maryland	Kansas

The Office of the Public Advocate, or its equivalent, in the States of:

Colorado	Missouri
District of Columbia	New Jersey
Georgia	New Mexico
Hawaii	Ohio

Illinois	Oklahoma
Indiana	Pennsylvania
Iowa	Utah
Maine	Washington
Florida	

The Department of Administration in the States of:

Illinois	South Dakota
Minnesota	Wisconsin

Q. On whose behalf are you testifying?

A. I am testifying on behalf of the Staff of the Arizona Corporation Commission (ACC Staff).

Q. Have you previously participated in any proceedings in Arizona?

A. Yes. I have participated in several previous matters in Arizona on behalf of the ACC Staff. I conducted a Cost of Service Study on behalf of the Staff of the Arizona Corporation Commission in an undocketed matter preparing a cost study pertaining to USWC. I participated in a general rate case, Docket No. E-1051-93-183, involving USWC on behalf of the ACC Staff; I participated in a depreciation docket, Docket No. T-01051B-97-0689, involving USWC on behalf of the ACC Staff; and I participated in the general rate case, Docket No. T-01051B-99-0105, involving USWC on behalf of the ACC Staff. On behalf of the ACC Staff, I have participated in several Phases of the Wholesale cost/UNE case Docket No. T-00000A-00-0194.

Q. What is the purpose of your testimony?

A. I address depreciation rates, the jurisdictional separations of the cost of the interstate

DSL service, "construction charges" pertaining to BSI (BSI is an affiliate which uses some Qwest facilities when providing cable TV-like services) and the "percent condition" used in the Reproduction Cost New Less Depreciation (RCNLD) calculations. This testimony also responds to related portions of Qwest's filing.

Q. Could you summarize your major recommendations?

A. Yes. For the reasons presented in this testimony:

(1) I recommend the adjustment shown on Schedule WDA-15. This adjustment is incorporated into adjustments B-3 and C-6 in the Staff accounting schedules. This adjustment removes from the intrastate jurisdiction the direct costs of interstate DSL service. 100% of the DSL revenues are in the interstate jurisdiction, but Qwest is placing the majority of the DSL costs in the intrastate jurisdiction. This is a mismatch of revenues and costs, and also violates the FCC Part 36 jurisdictional separations requirements.

(2) I recommend the Adjustments shown on Schedule WDA-18. This adjustment is incorporated into adjustments B-4 and C-7 in the Staff accounting schedules. This adjustment imputes the "construction charges" that BSI should have paid to Qwest Corporation (QC) for the "video only" remote terminals (USAMs) which QC constructed for BSI's needs. Qwest originally claimed BSI had paid these construction charges, but BSI had not.

(3) The current Qwest depreciation rates in Arizona are much higher than in any other Qwest state. I propose certain modifications to the Qwest depreciation calculations.

(a) I recommend the end-of-test-year "percent reserve" values be used in the depreciation rate calculations. Qwest is using the values as of the start of the 2003 test year, but the Commission filing requirements require end-of-test-year values be used. The result of this adjustment is shown in column H of page 1 of Schedule WDA-12. This adjustment is incorporated into adjustments C-22 in the Staff accounting schedules.

(b) Qwest's depreciation calculations assume that Qwest in Arizona will retire its metallic buried cable an average of 12 years after it is placed into service. However the actual Qwest Arizona data shows Qwest keeps these investments in service an average of 58 years.

In addition, in its depreciation calculation Qwest assumed \$228 million of investment would retire in the buried cable metallic account in the year 2003. The actual retirements in 2003 were \$5 million. Qwest effectively pretended the "service life" of \$228 million of investments ended in the year 2003 in this account, but that was not true for \$223 million[1] of that investment. As a result, Qwest is not depreciating over the true "service life." Failure to depreciate over the "service life" violates the ACC and

[1] (\$228 million - \$5 million = \$223 million).

USOA (Uniform System of Accounts) depreciation requirements. To correct these and other problems discussed in this testimony, I recommend a 23-year "projection life" for this account. My recommendation is also the mid-point of the FCC recommended life range for this account.

Based on similar analyses of the "projection lives" and "future net salvage" values of the major accounts, I recommend the depreciation rates shown in Column L of Schedule WDA-12, page 1. This adjustment is incorporated into adjustment C-23 in the Staff accounting schedules.

(4) I recommend the "percent condition" values shown on Schedule WDA-17, for reasons discussed in this testimony. The "percent condition" impacts the "fair value" rate base, but does not impact the "original cost" rate base calculations.

II. INTERSTATE DSL SERVICE

Q. What is DSL service?

A. DSL (Digital Subscriber Loop) is a broadband/wideband Internet transport service provided by Qwest.[2] In order to provide DSL service Qwest must have electronic equipment, known as DSLAMs, in the central offices or in the remote terminals.[3]

[2] The Internet service itself is not provided by Qwest. The DSL service addressed in this section is provided by the Qwest Corp., which is the same corporation that also provides a regulated intrastate services. This section does not address DSL services provided by BSI or any other Qwest affiliate.

[3] This does not imply this is the only equipment needed.

For separations purposes DSL is considered a "wideband" service.[4]

The FCC has declared that DSL service used for internet access is an interstate "Special Access" service (a form of interstate "private line"service).[5] For example, paragraph 1 of that FCC Order states:

> In this Order, we conclude our investigation of a new access offering filed by GTE that GTE calls its DSL Solutions-ADSL Service ("ADSL service"). We find that this offering, which permits Internet Service providers (ISPs) to provide their end user customers with high-speed access to the Internet, is an interstate service and is properly tariffed at the federal level.

Paragraph 25 states:

> We agree that GTE's ADSL service is a **special access service**, thus warranting federal regulation under the "ten percent" rule (emphasis added).

The DSL services addressed in this section are used primarily for Internet access.[6]

The fact that DSL is an interstate Special Access service means that all of the DSL revenues are to be booked as interstate revenues, and the DSL investments are to be "direct assigned" to the interstate jurisdiction.

Q. At the end of 2003, how much direct investment in interstate DSL service did Qwest Arizona have?

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[4] See Qwest response to WDA 8-15. In jurisdictional separations (47 CFR FCC Part 36) the term "wideband" is used. The term "broadband" is not used.

[5] October 30, 1998 FCC "Memorandum Opinion and Order" in CC Docket No. 98-79 (FCC 98-292), paragraphs 1,2 and 25) Interstate "Special access" is a form of interstate "private line" service. The FCC later extended this ruling to carriers other than just GTE. See the November 30, 1998 "Memorandum Opinion and Order" in CC Docket Nos. 98-168, 98-161, 98-167, and 98-103 (FCC 98-317).

[6] Qwest response to WDA 04-032 (g).

A. According to a Qwest discovery response, the Qwest-Arizona net "direct incremental DSL investment" in interstate DSL service at the end of 2003 was ** **.[7] This is shown on Schedule WDA-14

Q. How has Qwest treated the DSL revenues and costs?

A. Qwest has booked the DSL **revenues** to the **interstate jurisdiction**, which is proper based on the FCC's declaration of DSL as an interstate private line/special access services. However, Qwest placed the majority of the DSL **costs** in the **intrastate** jurisdiction, which is a mismatch of revenues and costs.

In request WDA 08-004 the Staff asked Qwest:

> The first page of Attachment B to the Qwest response to WDA 04-032 shows the "Direct incremental DSL investment" as of 12-31-2003....
>
> a. In the Part 36 separations of costs between jurisdictions for 2003, were each of these amounts directly assigned to the interstate jurisdiction?....
>
> Qwest answer:
>
> a. No.

The Qwest treatment of DSL revenues and major DSL costs in the test year 2003 is shown below:

[7] Qwest response to WDA-04-032.

	DSL Revenues	Major DSL Investments[8]
Intrastate Jurisdiction	0%	64%
Interstate Jurisdiction	100%	36%

The majority of the DSL expenses are also in the intrastate jurisdiction in the Qwest filing.[9]

Q. How does Qwest explain the fact that they place the majority of the DSL costs in the intrastate jurisdiction?

A. Qwest refers to FCC Order "FCC 01-162".[10] That Order froze **parts** of the separations calculations at the year 2000 level. Qwest alleges this FCC Order prevents Qwest from "directly assigning" the interstate DSL investments to the interstate jurisdiction.[11]

Q. Does that FCC Order prevent Qwest from "directly assigning" the interstate DSL service costs to the interstate jurisdiction?

A. No. That FCC Order does not freeze the "direct" assignments. In fact that Order specifically states states "direct assigned" costs are **not frozen**, and the Order requires

[8] See Qwest response to WDA 17-003.
[9] The allocation of the investment impacts the allocation of the expenses. In FCC Part 36 jurisdictional separations, depreciation expense and "plant specific" expenses (such as maintenance expenses) are separated based on how the investments are separated.
[10] FCC's "Report and Order" in CC Docket No. 80-286, released May 22, 2001.
[11] Qwest response to WDA 08-004(b).

"Direct assignment of private line service costs between jurisdictions shall be updated annually."[12]

From FCC Order Number FCC 01-162, Appendix C, "Final Rules"

> **§ 36.3 Freezing of jurisdictional separations category relationships and/or allocation factors**
>
> (a) Effective July 1, 2001, through June 30, 2006, all local exchange carriers subject to Part 36 rules shall apportion costs to the jurisdictions using their study area and/or exchange specific separations allocation factors calculated during the twelve month period ending December 31, 2000, for each of the categories/sub-categories as specified herein. **Direct assignment of private line service costs between jurisdictions shall be updated annually. Other direct assignment of investment, expenses, revenues or taxes between jurisdictions shall be updated annually...** (emphasis added)

In paragraph 23 of the text of that Order the FCC stated:

> 23. Similarly, we find that in order to relieve all carriers of performing traffic or relative-use studies for separations purposes, all allocation factors used to assign Part 36 categories, subcategories, or further subdivisions to the state or interstate jurisdictions shall be frozen utilizing the factors calculated for the calendar year 2000. **Categories or portions of categories that have been directly assigned in the past, however, will continue to be directly assigned to each jurisdiction. In other words, the frozen factors shall not have an effect on the direct assignment of costs for categories, or portions of categories, that are directly assigned. Since those portions of facilities that are utilized exclusively for services within the state or interstate jurisdiction are readily identifiable, we believe that the continuation of direct assignment of costs** will not be a burden on carriers, nor will it adversely impact the stability of separations results throughout the freeze.[60] (emphasis added)

and footnote 60 stated:

> 60. Examples of facilities in which a portion can be directly assigned include, Central Office Equipment- Category 2, Tandem switching equipment and Cable and Wire Facilities-Category 2, **Wideband** and exchange trunk. *See* 47 C.F.R. §§ 36.124 and 36.155. (emphasis added)

[12] 47 CFR §36.3(a).

Schedule WDA-16 contains the pages from the FCC Order that include the above quotations.

The FCC rules after the modification adopted in Order FCC 01-162 require that for circuit equipment:

> Direct assignment of any subcategory of Category 4.1 Exchange Circuit Equipment to the jurisdictions **shall be updated annually**. (47 CFR § 36.126, (c) (4))[13] (emphasis added)

The vast majority of the direct DSL investments shown on Schedule WDA-14 are "wideband" investments. The FCC specifically mentions "wideband" as **not** being frozen, as stated in the FCC's footnote 60 above.

Q. Are there other FCC rules that also say that wideband investments are to be directly assigned?

A. Yes.

FCC Rules §36.155 says:

> **Wideband and exchange trunk C&WF –Category 2-apportionment procedure.**
> (a) The cost of C&WF applicable to this category **shall be directly assigned** where feasible. If direct assignment is not feasible, cost shall be apportioned between the state and interstate jurisdictions on the basis of the relative number of minutes of use." (emphasis added)

The same rule applies to wideband exchange line circuit investment.[14]

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[13] The above requirement applies to the "Wideband Exchange Line Circuit Equipment-Category 4.11," which is the category that contains the majority of the DSL circuit equipment direct investment. The wording that "direct assignment … to the jurisdictions shall be updated annually" is the same for all categories of circuit equipment (Categories 4.1, 4.2, and 4.2)[13] and major Cable and Wire Facilities (47 CFR §36.126, (c) (4), (e)(4) and (f)(4)).

In summary of the above, the major DSL investments are "wideband" and separations requirements say the "wideband" investments are to be directly assigned, where feasible. The FCC "Separations Freeze" Order specifically says the "direct" assignments are not frozen and must be updated annually. The FCC Order specifically mentions "wideband" as an example of what is **<u>not</u>** frozen.

The interstate DSL wideband costs must be directly assigned to the interstate jurisdiction. Placing the **majority** of the interstate DSL **costs** in the **intrastate** jurisdiction is a mismatch of cost and revenues (all the DSL revenues are in the interstate jurisdiction), and is in violation of the FCC Part 36 jurisdictional separations requirements.

Q. What is Schedule WDA-15?

A. Schedule WDA-15 shows the correction that results from direct assigning the DSL "direct" investments out of the intrastate jurisdiction. The investments used in this calculation were the direct investments provided by Qwest as shown on Schedule WDA-14.[15]

The net direct DSL investment which Qwest included in the intrastate jurisdiction in 2003 was ** **. The associated expenses were ** **, as shown on Schedule WDA-15. These are the intrastate investments and costs that were removed in

[14] 47 CFR §36.126(c)(1) says the wideband exchange line circuit investment is to be apportioned "in the same manner as the related exchange line cable and wire facilities as described in §36.155," which is the requirement quoted above.
[15] From Qwest response to WDA-04-032.

the adjustment shown on Schedule WDA-15. These changes are incorporated into the Staff accounting adjustments B-3 and C-6.

100% of the DSL revenues are assigned to interstate. The costs of interstate DSL service should also be "directly assigned" to the interstate jurisdiction, and therefore directly assigned out of the intrastate costs, for the reasons given above.[16]

III. "CABLE TV LIKE" SERVICES PROVIDED BY BSI

Q. What issue will you discuss in this section?

A. Some Qwest Corporation (QC)[17] faculties are used by a QC affiliate, Broadband Services, Inc. (BSI), in providing TV/VDSL and other services.[18] These TV services are similar to cable TV services. In this section we will discuss the remote terminals, called USAMs. BSI generally owns the electronics used for these services, however QC generally owns the remote cabinets that house the BSI equipment and QC generally owns the cables used by BSI to provide these services. In Arizona, there are approximately 1000 QC USAM locations at which the QC cabinet contains BSI electronics, but does not

[16] This statement applies to the DSL costs shown on Schedule WDA-15. It is not implying any other DSL or private line adjustment should be made.
[17] Qwest Corporation is the company that provides the regulated services, including intrastate regulated services.
[18] VDSL (Very high bit rate digital subscriber line) is the technology that BSI uses to carry TV and other services over the QC copper cable.

also contain equipment used by QC for voice services.[19] I will call these the “video only” cabinets or “video only” USAMs.[20]

For technical reasons, the TV/VDSL signal cannot be sent over as long a copper cable as voice telephone service or DSL can.[21] Therefore to provide TV/VDSL it is reasonable to expect it would be necessary to build additional remote sites in order to bring the TV/VDSL electronics closer to the customers, to shorten the copper loop length. Qwest's response to a Staff data request:

> ***
>
> ”***[22] (note [“lengths”] added to correct typographical error.)

Q. Did BSI pay “construction charges” to QC for the locations where QC constructed cables and USAM cabinets to meet BSI’s needs?

A. In discovery over a several month period, Qwest repeatedly stated that BSI had paid “construction charges” to QC for the “video only” USAMs. When QC constructed cabinets to meet BSI’s needs, “construction charges” under Section 4 of Qwest's Arizona Exchange and Network Services Price Cap Tariff should have applied. Qwest repeatedly said BSI had paid QC construction charges for such locations.

---

[19] Qwest supplemental response to WDA 17-08(c). In this section we are only addressing the USAMs installed after March 2,1999 (when BSI became responsible for the TV/VDSL services). There is additional related information in the confidential response to WDA 14-001.

[20] There are also over *** *** other QC USAM cabinets which house both QC electronics used for voice, and BSI electronic. (Qwest response to WDA 12-003)

[21] Choice TV can be sent over a maximum of 5,200 feet of copper (Qwest response to WDA-027). DSL can be provided over 13,000 feet of copper (Qwest response to WDA 14-003S1) (Public information)

[22] Qwest supplemental response to WDA 12-009(j).

Examples of Qwest's repeated statements that BSI had paid such construction charges include:

***

.***(Qwest response to WDA 14-001(a))

Another Qwest claim that BSI paid the construction charges is:

***

*** (Qwest response to WDA 14-001(b))

In response to another request about "video only" USAMs, Qwest responded:

*** ***

(Qwest response to WDA 14-001(i))

Statement:

*** .***

Qwest response:

***

***[23]

Q. Had BSI paid these construction charges?

A. No. In spite of these numerous statements by Qwest that claimed BSI paid these construction charges, the Staff was not receiving documents from Qwest that showed the amount of the construction charges BSI had allegedly paid. Finally, in a supplemental response dated November 3, 2004, Qwest acknowledged **BSI paid no construction**

[23] In WDA 12-009, Qwest was asked to confirm that the following are reasonable representations of statements made by Qwest personnel during the Staff on-site visit of September 9, 2004.

charges for the "video only" USAMS. Qwest stated pertaining to the "video only" USAMs:[24]

> WDA 17-008 (e) **BSI paid no construction charges** associated with the items included in subpart d. Qwest wishes to clarify it statement to Mr. Dunkel that "BSI paid construction charges for the construction of the USAM "video only" remote locations." A more accurate statement would be the following:
>
> The capital budget for construction of the USAM "video only" remote locations is held at the parent company, in a "VDSL program budget."
>
> The parent corporation assigns a portion of the parent company VDSL program budget to QC for the construction of USAM cabinets and for fiber placement. The parent corporation also assigns a portion of the VDSL program budget to BSI for the placement of shelves and cards. Qwest's statement that "BSI paid construction charges for the construction of the USAM 'video only' remote locations reflected the respondents' incorrect understanding that because QC was assigned budget dollars for VDSL related construction, QC received actual cash compensation from BSI for the capital expended for VDSL related construction.
>
> Confidential Attachment D shows the VDSL expenditures that were authorized and shows which come encourage expenditures related to each of the 10 sites. (emphasis added)

Qwest acknowledged Qwest's "respondents" were incorrect in their prior claims that BSI had paid these construction charges. Qwest's response to part (g) also states BSI paid no construction charges for the new cables QC installed to the "video only" USAMs.

Q. Are the QC investments in the cabinets and cables which QC installed to serve BSI's needs in the Qwest rate base?

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[24] Part (d) of WDA 17-008 referred to "the dollar amount of the Engineer, Furnish and Install (EF&I) investment for the cabinet, site preparations, connection to the electric utility and other items owned by Qwest "core" company at that location." Of the "video only" USAMs.

A. Yes. Qwest has these investments in its regulated rate base. In response to WDA 17-008 (m) Qwest stated:

> It is a correct statement that the intrastate portion of the investments discussed in parts (b) and (f) are in the intrastate (original cost) plant in service in this case. Is also a correct statement that the investments have been depreciated and that the intrastate portion is included in the intrastate accumulated depreciation in this case. Finally, QC is being compensated for this investment through the monthly recurring charges paid to QC by BSI.

Q. Is the above statement that "QC is being compensated for this investment through the monthly recurring charges paid to QC by BSI" a reasonable compensation for this investment?

A. No. The vast majority of Remote Collocation revenues are from the non-recurring charges. ***

***

According to Qwest discovery responses, the Remote Collocation charges used by Qwest in 2003 for are as follows:[25]

Remote Collocation	Recurring	Non-Recurring
Space per Standard Mounting Unit	$1.35	$868.13
FDC Terminations per Binder Group	$0.82	$558.99
Power	$3.64	

At the above rates, an un-affiliated CLEC that used a "Standard Mounting Unit" in a QC remote terminal for 5 years would pay $949.13[26] over that period. ***

[25] Attachment A to Qwest response to WDA 11-05, also Attachment A to WDA 10-15. In the current Qwest Arizona Statement of Generally Available Terms and Conditions for Interconnection (SGAT) the Remote Collocation Non-Recurring Rates are also large compared to the month rates.
[26] $868.13 NR + (60 months * $1.35) = $949.13

***

At the above rates, an un-affiliated CLEC that used an "FDC Terminations per Binder Group" in a QC remote terminal for 5 years would pay $608.19[28] over that period.

***

***

Q. Did Qwest acknowledge that BSI ***

*****

A. Yes. In response to discovery, Qwest ***

***[30]

Request WDA 14-001 was:

(a) Please explain why Attachment A to the Qwest response to WDA 10-015 **

*** for remote collocation in the year 2003.

Qwest Response:

(a) ...***

***

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[27] 60 months * $1.35 = $81.00

[28] $558.99 NR + (60 months * $0.82) = $608.19

[29] 60 months * $0.82 = $49.20

[30] Qwest response to WDA-10-15. and WDA 14-001.

The above Qwest response states *** *** We later found out BSI did not pay the remote terminal construction charges either, as previously discussed.[31]

In addition, Qwest's data responses for the years 1999 through 2003 also show BSI paying *** ***[32] The reality is BSI did not pay the remote terminal construction charges, and also *** ***

Q. How much does BSI pay QC for the average USAM remote location?

A. BSI pays QC less than *** *** per USAM location which BSI uses.[33] In 2003 BSI paid QC a total of *** *** per month for remote collocation and the terminations at the remote collocations.[34] BSI had equipment in over *** ** QC USAMs.[35] That is less than *** *** per USAM location which BSI uses.[36]

The QC average investment in the installed "video only" USAM cabinet, site preparations, and connection to the electric utility is over *** ***.[37] Any

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[31] This is referring to the "video only" USAMs installed after 3/2/1999.

[32] Qwest response to WDA 14-001(c) and (d) and confidential attachment A, Qwest response to WDA-10-15

[33] This include for the remote cabinet, site preparations, connection to the electric utility. This does not include BSI payment for cable, or collocation in the central office.

[34] Lines 50, 59, and 132, confidential attachment A, Qwest response to WDA-10-15.

[35] *** ***. Qwest response to WDA 12-003

[36] *** ***

[37] From Qwest Confidential Attachment B to WDA 17-8S1. This does not include cable costs. It includes furnished, engineered and installed, cabinet, site preparations, and connection to the electric utility.

reasonable calculation of the costs (cost of money, depreciation, maintenance, what QC pays for electricity, etc) would be a cost of several hundred dollars a month on a *** *** investment. At those QC owned USAMs that contain only the BSI video cards, the average of *** *** per month paid by BSI is the only QC revenue generated by that *** *** investment. [38]

Q. What would have been done with the construction charges if BSI would have paid them?

A. Construction charges are applied as reductions to the gross plant in service.[39] Had BSI paid the construction charges, the QC intrastate rate base would be lower than what Qwest has filed.

Q. What is Schedule WDA-18?

A. Schedule WDA-18 shows the adjustment to the intrastate rate base and depreciation expense as a result of adjusting for the construction charge which Qwest should have paid for the "video only" USAMs.[40] I recommend these adjustments be made for the reasons presented above. These changes are incorporated into adjustments B-4 and C-7 in the Staff accounting schedules.

Q. Do you have any other comment on this issue?

---

[38] BSI does pay other charges, not addressed above, such as for Collocation in the central offices, or for cables, but the costs for those are not included in the investment discussed above. This discussion addresses only the Remote Collocations.

[39] Qwest response toe WDA 04-023(a)

[40] I have not included any adjustment for the USAMs which include both BSI video and QC voice cards.

A. Yes. Staff had asked for, and received a delay in our testimony filing date. It was only after our original October 19, 2004 filing date had passed that we obtained the Qwest November 3, 2004 response in which Qwest admitted that BSI had not paid the remote terminal construction charges.[41] Had we filed on our original October date, we would not have had the correct information on this issue.

Qwest has also discussed the complexity of some of my discovery. The discovery was instrumental in revealing the inaccuracy of what Qwest had been telling the Staff about the alleged BSI construction charges. The Qwest admission that BSI did not pay construction charges on the "video only" USAM cabinets was in response to part (e) of a request (WDA 17-008). The Qwest admission that BSI did not pay construction charges on the new cables which QC installed to connect to those "video only" USAMs was in response to part (g) of that request. The Qwest admission that the separated portion of the QC investments in the "video only" USAMs were in the intrastate rate base in this case was in response to part (m) of that request. It took significant discovery to obtain the facts to be placed before the Commission. As the results show, the Staff was pursuing real and significant issues.

IV. DEPRECIATION ADJUSTMENTS

Q. What depreciation rate adjustments will you be addressing in this testimony?

A. I will be addressing two depreciation rate adjustments:

[41] Qwest supplemental response to Parts (e) and (g) of a request WDA 17-008.

1. Adjusting the depreciation "percent reserves" to the end-of- test year 2003 levels; and
2. Adjusting to the projection lives and net salvage values to reflect the current information pertaining to Qwest in Arizona.

Q. Are the current Qwest depreciation rates in Arizona extremely high?

A. Yes. The depreciation rates in Arizona are much higher than the depreciation rates in any other Qwest state. The overall Qwest intrastate depreciation rate in Arizona is 9.7 percent. Out of the 15 state jurisdictions, the **next** highest Qwest overall intrastate depreciation rate is 7.8 percent in Wyoming, and the overall depreciation rates in all other Qwest jurisdictions are lower than that.[42] Schedule WDA-1 is a comparison that was provided by Qwest and shows the Qwest depreciation rates in Arizona are much higher than in any other Qwest state. These high depreciation rates when into effect in Arizona in 2000.

Q. As discussed above, for the past four years the depreciation rates in Arizona have been much higher than the depreciation rates in any other Qwest state. What impact do these past high rates have on the depreciation rates that should be adopted now?

A. Under the "remaining life" depreciation that is used in Arizona, higher depreciation rates in the past results in lower depreciation rates for the future.

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[42] Data provided by Qwest. See Qwest response to (WDA 04-006). There are 15 state jurisdictions. Qwest operates in 14 states, but Idaho North and Idaho South are treated as two different regulatory service areas.

As an analogy, assume that two people owed $2,000 each, which had to be paid off in two years. Assume one person paid $1,000 toward that debt the first year. That means they have to pay $1,000 the second year. The other person paid $1,500 towards that debt the first year. That means they only have to pay $500 towards that debt the second year.

The customers in Arizona are similar to the second person in this analogy: for the past several years Arizona customers have been supporting depreciation rates which are much higher than the depreciation rates in any other Qwest state. As a result, we should expect that the properly calculated new Arizona depreciation rates would be lower than average.[43]

Q. Has Qwest proposed a change in depreciation rates in this proceeding?

A. Yes. Qwest proposes to revise the depreciation rates to incorporate the depreciation "percent reserve" and investment amounts[44] as of the **start** of the 2003 test year (amounts as of 1/1/2003).[45] This revision reduced the intrastate depreciation expense by $109.7 million per year, according to Qwest. Qwest calculated this amount based on the "percent reserve" and investments at the **start** of the test year (amounts as of 1/1/2003).[46]

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[43] The depreciation "accruals" go into the depreciation reserve ("Accumulated Depreciation"). When actual retirements occur, funds are removed form the depreciation reserve. Since the "accruals" have been higher than the retirements, the amount in the depreciation reserve has grown rapidly. In a "remaining life" depreciation calculation, the depreciation reserve is used in the calculation of the revised depreciation rates. A higher depreciation reserve results in lower depreciation rates.

[44] A table of the surviving investments by year installed, (called the "generation arrangement") is used in the depreciation "remaining life" calculation.

[45] Exhibits KDW-2 of the direct testimony of K. Dennis Wu, Qwest. The "generation arrangements" as of 1/1/2003 were also used in this calculation.

[46] Based on the generation arrangement and percent reserves as of December 31, 2002 (Exhibit KDW-2) also called 1/1/03 (Exhibit KDW-1).

Q. Is there a problem with Qwest's proposed use of the percent reserve and investments as of the start of the 2003 test year?

A. Yes. Qwest adjusted these "percent reserve" figures to the **start** of the test year level. However, the Commission rules require that the **end** of the test year figures be used.

For example, R14-2-103 A.(3)(h) defines "original cost" as determined "at the end of the test year".

There are also numerous other requirements in R14-2-103 to use the "end of the test year" figures.[47]

Q. Has the Qwest percent reserve in Arizona grown rapidly since the higher depreciation rates went into effect?

A. Yes. Shown below are the overall Qwest Arizona percent reserve levels at the end-of-year:

[47] For example, R14-2-103 A.(3)(n) and R14-2-103 A.(3)(p).

	1996	1997	1998	1999	2000	2001	2002	2003
Percent Reserve:[48]	45%	47%	49%	50%	49%	50%	56%	62%
Change over Prior Year:		2%	2%	1%	-1%	1%	6%	6%

The "accruals" that result from the depreciation rates go into the depreciation reserve. When plant is retired, money is removed from the depreciation reserve. When the accruals from the depreciation rates are much higher than the actual retirements, that in-balance results in a rapid growth of the depreciation reserve.

A. UPDATE DEPRECIATION RESERVE TO END OF TEST YEAR

Q. What is the first depreciation rate correction that Staff proposes?

A. The first Staff depreciation rate correction is to calculate the depreciation rates using the depreciation reserve percents and investments that existed at the **end** of the test year, instead of the depreciation reserve percents and investments that existed at the **start** of the test year. The percent reserves are significantly higher at the end of the test year then they were are the start of the test year. At the start of the 2003 test year the overall percent reserve was 55.8%.[49] At the end of the test year the overall percent reserve was 62.1%.[50] Higher depreciation reserves result in lower depreciation rates.

[48] Intrastate Arizona Qwest percent reserve (depreciation reserve as a percent of Plant in Service). End of year figures. Source Qwest response to WDA 02-026 (Public information)
[49] Wu Exhibit KDW-1, "Intrastate Statement C".
[50] Page 4 of Schedule WDA-2, attached (this is a page from Qwest response to Staff request WDA 02-005). Note, the specific percent reserve for each account is used in the depreciation rate calculation.

Q. Why does the "percent reserve" impact the depreciation rates?

A. Percent reserve is one of the three values that is used to calculate the depreciation rate. The formula used to calculate the depreciation rates is as follows:

Depreciation rate = (100%-(percent reserve)-(future net salvage))/ (avg. remaining life)

The values specific to the specific company and specific account are used in the calculation.

Q. What is the impact of using the percent reserve figures from the end of the test year, instead of the percent reserve as of the start of the test year?

A. The result of this correction is to reduce the annual intrastate depreciation accruals by approximately[51] $163 million below the current rates.[52]

Q. What is a source of these revised figures that utilize the end-of-test-year depreciation reserves and investments?

A. These revised calculations were provided by Qwest during the discovery process. Page 3 of Schedule WDA-2 shows the Qwest calculation of $163 million reduction in annual

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[51] All depreciation dollar impacts in this testimony are approximate. I recommend depreciation rates. Other Staff witnesses apply those depreciation rates to the investments. Adjustments may have been made to their investment amounts, so the impact of the depreciation rates may be somewhat different than the approximate impacts discussed herein.

[52] This figure was provided by Qwest in response to WDA 01-010 and 02-005, pages from these responses are attached as Schedule WDA-2.

intrastate depreciation accruals below current rates when the end-of-test-year percent reserves and end-of-test-year investment levels are utilized.[53]

I performed a similar calculation with similar results. Details of this adjustment are shown on Schedule WDA-12, page 2, column T.

Using the end-of–test-year percent reserve, the annual depreciation expense is $163 million lower than under the current rates. However, Qwest had already proposed some adjustment from the current rates, as previously discussed. The result of this Staff correction is to reduce the annual intrastate depreciation expense by $53 million more than the Qwest adjustment, as is shown on line (1) of Schedule WDA-3.

Q. What do you recommend on this first depreciation rate issue?

A. I recommend that the percent reserves as of the end-of-the-test-year be utilized in the depreciation rate calculations. These are the 12/31/2003 values. The use of the end-of-the-test-year figures is consistent with the Commission's standard filing requirements.[54] This correction is incorporated into adjustment C-22 in the Staff accounting schedules.

B. UPDATE DEPRECIATION "LIVES" AND "NET SALVAGE"

Q. What is the second depreciation adjustment that Staff proposes?

[53] This figure was provided in response to request WDA 02-005. Request WDA 02-005 was a follow-up to request WDA 01-010. The last page of Schedule WDA-2 is the WDA 01-010 request, to clarify what was issue being addressed in these calculations.

[54] For example, R14-2-103 A.(3)(h) defines "original cost" as determined "at the end of the test year". There are also numerous other requirements in R14-2-103 to use the "end of the test year" figures. (For example, R14-2-103 A.(3)(n) and R14-2-103 A.(3)(p)).

A. The second depreciation adjustment that Staff proposes is to revise the depreciation rates based upon more current Qwest Arizona "life"[55] and "future net salvage" information. "Average remaining life" and "future net salvage" are two factors that are used in the calculation of the depreciation rates (along with the previously discussed "percent reserve").

As stated on page 8 of the Direct Testimony of K. Dennis Wu, the current Arizona depreciation rates were based on information as of 1/1/1997. In this proceeding Qwest does not propose to update the "lives" or "future net salvages" used in the depreciation rate calculations. We now have seven additional years of more recent information. Staff included this more recent information in determining revised "lives" and "future net salvages" for Qwest in Arizona. The differences in "future net salvage" values are relatively insignificant except in one account,[56] so this adjustment is primarily related to differences in "lives."

Q. Why are the current Arizona depreciation rates much higher than in any other Qwest jurisdiction?

A. The major reason is that in the last depreciation case in Arizona, Docket T-01051B-97-0689, Qwest advocated adopting short projection lives for most major accounts. Qwest presented a witness and a study that alleged the there would soon be a massive, accelerated modernization and retirements. As a result, they projected massive retirement of the existing investments in the near future. According to that Qwest presentation, the

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[55] The "projection live" is a key factor used in the calculation of the "average remaining life."
[56] The "future net salvage" issue is significant in the "poles" account.

"projection lives" used in the depreciation calculation had to be shortened drastically because of this upcoming massive modernization.[57] Qwest also alleged the Commission should base Qwest's depreciation rates on information pertaining to IXCs and CLECs.

In that case, the Commission generally adopted drastically shortened projection lives for many major accounts.

The short "lives" resulted in much higher depreciation rates and a much higher depreciation expense. These higher depreciation rates went into effect in May 2000.[58]

Q. Did the forecasted massive accelerated modernization actually occur?

A. No. In fact Qwest's construction expenditures in Arizona actually have **declined greatly** after the higher depreciation rates went into effect in the year 2000.

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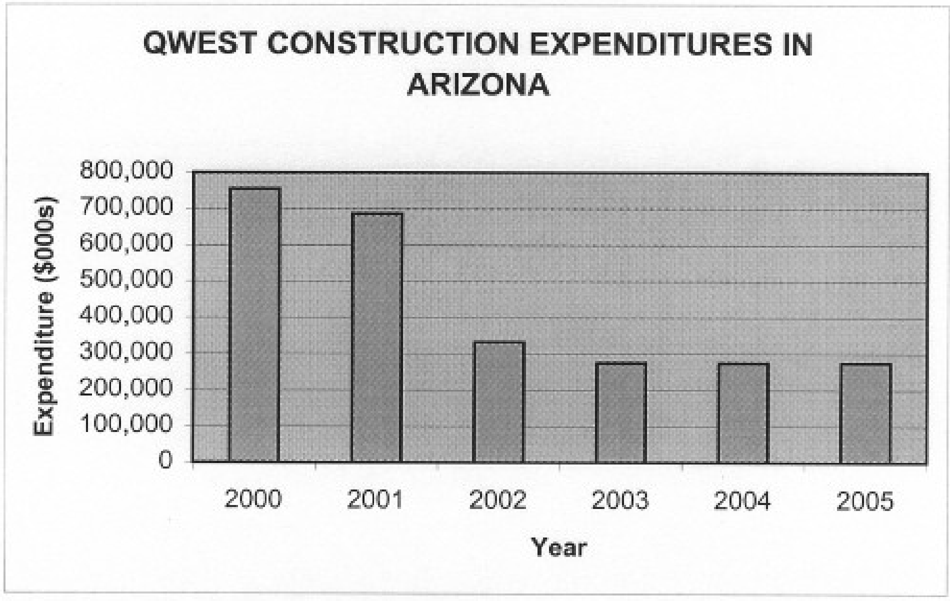
[57] Lawrence K. Vanston, Qwest witness in Docket No. T-01051B-97-0689, who also authored "Transforming the Local Exchange Network" used by Qwest in that case.

[58] Qwest response to WDA 02-003



This graph is also attached as Schedule WDA-4.

The Qwest construction expenditures in Arizona are now one-third what they were in the year 2000. In addition, Qwest now forecasts that its construction expenditures in Arizona will continue to be one-third of what they were in 2000.[59]

It is now very clear that Qwest did not undertake the massive accelerated modernization that was forecast. For the last four years the ratepayers in Arizona have been supporting high depreciation rates on the basis of a forecast of near term massive accelerated modernization and retirements, but the massive accelerated modernization and retirements never actually happened.

Q. What is Qwest effectively asking the Commission to do in this proceeding?

[59] Qwest forecasts construction in Arizona in 2005 as the same as it was for 2003. (Schedule F-3 of the Qwest standard filing requirements in this case.)

A. In this filing Qwest is again effectively asking the Commission to calculate depreciation rates based on the assumption of massive retirements occurring in the near future.

Q. What is the "projection life"?

A. The "projection life" is used in the calculation of the "remaining life". A "projection life" is the average life expectancy of new assets. This is the average number of years between the time a new investment goes into service, and the time it is expected to retire from service. The "remaining life" is the average of the future life expectancies of all items in a particular plant account.

Q. What "projection life" did Qwest use for the largest depreciable account, which is the Buried Cable Metallic account?

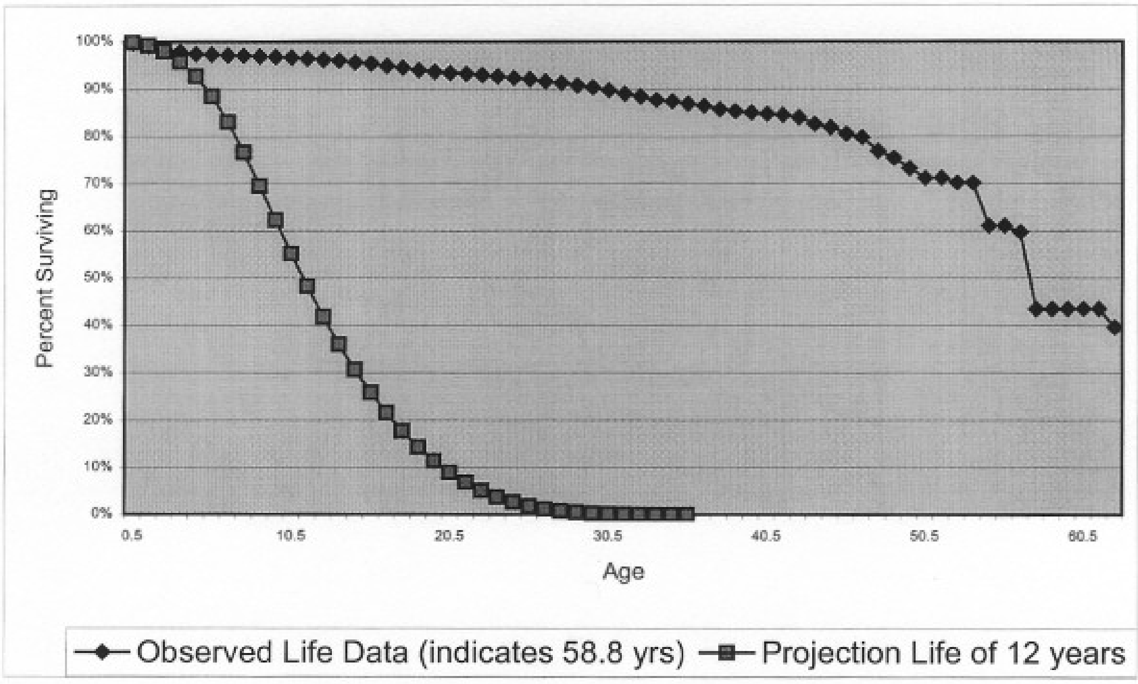
A. Qwest used a 12-year "projection life," which results in a 5.5 year average "remaining life."

Q. How does a 12-year "projection life" compare to the actual recent experience of Qwest in Arizona in this account?

A. For this account, graphed below is a comparison of the Qwest Arizona "observed" survivor curve to the survivor curve for the 12-year "projection life"[60] that Qwest is using:

[60] The "dispersion" (Iowa curve) used is also the same as Qwest is using. The 12 year projection life is the same as Qwest is using.

Graph of Recent Observed Life Data and Qwest Projection Life
Account 2423 - Buried Cable - Metallic



As this shows, the 12-year projection life does not match the actual recent experience and data of Qwest in Arizona. This graph is also part of Schedule WDA-19.

Q. What is the actual observed average service life in the buried cable metallic account of Qwest in Arizona?

A. Based on the most recent data,[61] the observed average service life in the buried cable-metallic account of Qwest in Arizona is 58.8 years. This observed life figure was

[61] The data in the chart above was from activities in this account for Qwest in Arizona in the years 2001, 2002, and 2003.

calculated by Qwest and provided to the Staff.[62] A copy of the Qwest response that provided the 58.8-year observed life is attached as Schedule WDA-10.[63]

Q. Is Staff proposing a 58.8-year projection life for this account?

A. No. The FCC has established "ranges" in which the projection lives for various accounts are expected to fall. The FCC uses the ranges for determining the cost to be included in the High Cost Fund (HCF), for purposes of setting unbundled network element (UNE) and interconnection rates, and to determine the reasonableness of the price of new services.[64] To be conservative, Staff is not recommending a revised projection life for any account that is longer than the midpoint of the FCC range for that account.[65] This is a reasonable, but conservative, step at this time. For buried cable metallic the FCC range for projection lives is 20 to 26 years. As a result, the Staff recommendation is a 23-year projection life, although the actual current data shows that Qwest in Arizona keeps their investment in this account in service much longer than a 23 year average. Since the investment in this account is already 12.4 years old on average, the observed life indication is over 58 years, and Qwest has no plans for massive retirements in this account, the expectation that these investments will retire an average of 23 years after they when into service is very conservative.

[62] Attachment A to Qwest's response to WDA-02-06S1. As is the accepted practice, the most recent "band" was used. This figure is based on the retirements and other data for the years 2001, 2002, and 2003. None of the data in these years existed at the time of the prior Qwest depreciation case in Arizona.

[63] This calculation used the accepted method of analyzing data to determine the observed average life. This accepted method looks at the percent of the investment that retires each year of life, in the actual data of Qwest in Arizona.

[64] Paragraphs 34 and 39, FCC Order 99-397 CC Docket No. 98-137, released December 30, 1999.

[65] For some accounts the existing projection life was supported by the data and we have not changed those existing approved projection lives. Some of those existing projection lives were outside the FCC range. But any change in projection lives Staff proposes are all with the FCC range.

As stated above, the observed life in this account is well in excess of 23 years based on the most recent information.[66]

Staff recommends a 23-year projection life for the buried cable-metallic account, which results in a 12.0-year average remaining life, as shown on schedule WDA-11.

Q. Does this recommendation assume the future will be identical to the past?

A. No. This proposal does not assume that the future will be identical to the past. Using 23 years instead of the "observed" 58 years average life means Staff has included a generous allowance for the possibility that the investments may live a shorter average life in the future than they have in the past.

Q. Is Qwest planning any widespread retirement of buried metallic cables?

A. No. There are three different Qwest sources that indicated that Qwest is not planning a massive retirement of the existing buried cable metallic investments:

(1) A recent Wall Street Journal Article stated:

> Qwest Communications International Inc., the local phone company in 14 Western states, has decided to roll fiber out only to new housing developments, and its chief executive officer, Richard C. Notebaert, has dismissed a blanket rollout of the technology as not economical.[67]

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[66] Based on Qwest's activity in the years 2001, 2002, and 2003. Qwest had a larger retirement in 2000 than in other years, but the overall average of the data since the prior Qwest depreciation case is consistent with the Staff's recommendation.

[67] November 8, 2004 Wall Street Journal article entitled "Showdown of the Giants", by Jesse Drucker, Dennis K. Berman and Peter Grant.

(2) In Schedule F-3 of R-14-2-103 standard filing requirements, Qwest's forecast for its construction budget through the year 2005 is the same construction level it had in 2003, so no massive accelerated replacements are forecast by Qwest.[68]

(3) In request WDA 04-11 we asked Qwest:

> WDA 04-011 (a.) Please provide a copy of any QWEST plans for the widespread retirement of Buried Cable-Metallic in the distribution portion of the network.

In response they provided no copy of any such plans. Qwest stated:

> a. Any Qwest retirement plans are provided and disclosed at http://www.qwest.com/disclosures/.

A review of that website contained no Qwest plans for the widespread retirement of buried metallic cable.

Q. If Qwest does start installing a different technology "only to new housing developments" does that mean that existing buried cable in the existing housing developments will be retired quickly?

A. No. That would indicate the existing cable would continue to be used in the existing housing developments. Of course, everything retires someday, the Staff proposal for the buried cable metallic account includes a projection life of 23 years (which results in an average remaining life of 12 years). The projection life of 12 years (which results in an average remaining life of 5.5 years), which the Company proposes, is not realistic and is inconsistent with Qwest's own plans. Qwest's calculations effectively assume that all of

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[68] Also, see the Confidential file provided by Qwest titled "Inputs-1203.xls" shows ** **

the metallic buried cable that Qwest had in service on 1-1-2003 would retire an average of 5.5 years after 1-1-2003, which would be in the middle of the year 2008, on average. To retire all the existing buried metallic cable in an average of 5.5 years would require a massive project by Qwest, which Qwest is not planning to undertake. As previously stated, Qwest has "dismissed a blanket rollout of the technology as not economical" and is limiting any change "only to new house developments."

C. THE QWEST DEPRECIATION CALCULATIONS VIOLATE THE ACC AND USOA UTILITY DEPRECIATION REQUIREMENTS.

Q. What is a related problem with the Qwest depreciation calculations?

A. The Qwest proposal violates the ACC and Uniform System of Accounts (USOA) utility depreciation requirements. The ACC and USOA both require that investments be depreciated over their "service life." The "service life" ends when the investments retire from service. However for purposes of calculating the depreciation rates, Qwest ends the investments alleged "life" before they actually retire, so Qwest is not depreciating the investments over their "service life."

Q. What is the Arizona Administrative Code definition of depreciation for regulated utility purposes?

A. The Arizona Administrative Code, Section R-14-2-102(A)(3) states:

> 'Depreciation' means an accounting process that will permit the recovery of the original cost of an asset less its net salvage over the <u>service life</u>. (emphasis added)

Section R14-2-102(B)(3) requires:

> The cost of depreciable plant adjusted for net salvage shall be distributed in a rational and systematic manner over the estimated service life of such plant. (emphasis added)

Section R14-2-102(A)(9) states:

> 'Service life' means the period between the date an asset is first devoted to public service and the date of its retirement from service. (emphasis added)

Q. What is the USOA definition of depreciation for regulated telephone utility?

A. The FCC and ACC both use the Uniform System of Accounts (USOA) for Telecommunications Companies (FCC Part 32, 47 CFR, Ch. 1). The USOA requires that depreciation be over the "service life."

Under "Depreciation Accounting", the USOA requires that:

> …the loss in service value of the property …be… distributed under the straight-line method during the service life of the property." (emphasis added, §32.2000(g)(1))

That service life ends when the investment is "retired from service". (USOA Part 32.2000(d))

Q. How much investment retired in the Qwest Arizona buried cable metallic account in the year 2003?

A. As shown on Schedule WDA-5, Qwest retired $5.1 million in this account in the year 2003. This means the "service life" of $5.1 million of investment ended in the year 2003 in this account.[69]

Q. For purposes of calculating the average "remaining life" used in their depreciation calculation for this account, what retirements in the year 2003 did Qwest assume?

A. For purposes of calculating their depreciation rate, Qwest assumed $228 million of "retirements" for Qwest in Arizona in this account (the buried cable metallic account) in the year 2003. Qwest effectively pretended the "service life" of $228 million of investment ended in the year 2003 in this account, although that was not true. The "service life" of $223 million out of that $228 million continued past 2003. So Qwest is not using the "service life" of that $223 million of investment.[70]

Schedule WDA-6 summarizes the year 2003 "retirements" that are assumed in the Qwest depreciation calculation. The Qwest "remaining life" depreciation calculation assumes retirements in 2003 that are 44 times the actual 2003 retirements in this account.[71] Qwest's depreciation calculation has no relationship to reality and is not using the "service life." The service life ends on the "date of retirement from service," but Qwest is removing massive amounts of investment from the depreciation calculations before those investments "retire" (ending their "average service life"). The resulting Qwest

[69] As shown on Schedule WDA-5, in most recent years the retirements in this account have been in the range of $5 to $7 million dollars per year. The highest retirement year was $46 million, and the lowest $0.4 million. As previously discussed, Qwest's construction plans as far ahead as they provided information (through 2005) are similar to what they were in 2003, so Qwest has no plans for massive retirements in the foreseeable future. The average retirement in this account was $9 million per year over the last ten years.
[70] The problem is not limited to the year 2003 in the Qwest calculation.
[71] The retirements in other years in the near future are also excessive, in the Qwest depreciation calculation.

"remaining life" figures, and resulting Qwest depreciation rates, also have no relationship to reality.

For many other major accounts the year 2003 "retirement" amounts used in the Qwest depreciation calculations were also many times the actual 2003 retirement amounts, which effectively means Qwest is not depreciating over the "service life", as discussed above.

The Qwest proposed depreciation rate for the buried cable metallic account is inconsistent with the USOA and ACC requirements that the depreciation be over the "service life."

For depreciation purposes, Qwest is effectively pretending that Qwest is currently involved in massive, accelerated retirements and modernization in Arizona, but it really is not. Customer should not pay real money for imaginary retirements.

Q. What is Schedule WDA-7?

A. This is a response from Qwest that confirms our understanding of the year 2003 retirements they had included in their "remaining life" calculation was correct.

Q. How does the Qwest massive overestimate of the 2003 retirements impact the depreciation rates Qwest is recommending?